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**The Business Side of Holding
Out Income Tax on
Coupons, Etc.**

**Report of
Trust Companies Committee**

Trust Companies Committee.

TO THE TRUST COMPANIES OF NEW YORK CITY:

The undersigned Committee, appointed on March 21, 1913, to urge upon the Committees of Congress having charge of the proposed taxation of incomes certain features with respect to the collection of taxes under the Act, begs leave to submit the following report:

Since the date of the organization of the Committee, it has, with the assistance of its accountant and its counsel, endeavored to bring to the attention of the Committees of Finance in the United States Senate and to the Conference Committee of the Senate and House, to the members of the Committee on Ways and Means of the House that had particular charge of the Income Tax Law, certain recommendations with respect to the administrative features of the Bill. The Committee prepared a printed brief on behalf of the Trust Companies, a copy of which you have no doubt received.

It is impossible, within the confines of a communication of this character, to enumerate the many provisions to which this Committee called the attention of the Committees of Congress, but the principal amendment urged by this Committee was the adoption of the "information at the source," in lieu of "stoppage at the source," as provided in the Bill. In this respect the Committee was unsuccessful in its efforts before the Conference Committee, although individual members of both the House and the Senate expressed themselves strongly as believing that the system advocated by the Committee was preferable to that contained in the Bill.

In the original draft of the bill the provision relating to the stoppage of corporate interest covered "bonds, mortgages and other INDEBTEDNESS" of corporations. This would obviously have included among many other matters, the thousands of deposit accounts in all the banks of the country. Your committee made an especially serious effort to have this clause more clearly

defined, and the Senate committee changed the passage so that it now reads "bonds and mortgages or deeds of trust and other similar obligations"—a very much more restricted category and apparently what was actually originally intended.

When the bill was in the Senate that body inserted an amendment taxing non-resident foreigners. This taxing would have been unfortunate, as this country is a borrowing nation, and the investment of foreign capital for the development of the country should be encouraged as much as possible. Your Committee made strong representations on this subject, and Congress was apparently impressed with the wisdom of this policy and the Senate amendment was stricken out.

Since the passage of the law the Committee has been giving attention and study to the effect the law and the Treasury Department regulations will have on trust companies and general business. You have probably seen the regulations just issued by the Treasury Department, respecting the deduction of the tax on bond interest which presented one of the most complicated phases of the whole matter, and there is also sent you herewith a statement prepared by Mr. Stuart H. Patterson, the expert employed by your Committee, explaining the business side of the regulations issued.

Your Committee believes that these regulations are in the main satisfactory, and in certain respects accomplish what the Committee believe should be inserted in the bill. The requirement that the certificates of partnership shall show the respective interest of each partner in the bonds we, however, believe to be impracticable and unnecessary, as under the law the authorities can secure a statement of profits, etc., from every partnership and this information could be secured at such time and make unnecessary a repetition of it on tens of thousands of certificates of ownership.

The Committee will be glad to answer, as far as possible from its study of the Bill and regulations, any inquiries that may be put to it and will be glad to obtain an opinion of counsel or accountants of the Committee,

upon questions suggested by a Trust Company member.

Further reports if deemed necessary will be made to you from time to time as additional regulations are issued respecting rents and other matters.

Respectfully submitted,

ALEXANDER J. HEMPHILL,
Chairman,

WILLIAM B. CARDOZO,

OTTO T. BANNARD,

EDWARD O. STANLEY,

CALVERT BREWER,

New York, October 27, 1913.

Committee.

Business Side of Holding Out Income Tax on Coupons*

By STUART H. PATTERSON

The Treasury Department regulations just issued relative to holding out the tax on bond interest, are clear as to what shall be done from the Government's point of view, but an outline of the effect the regulations will have on business conditions may be helpful to banks, trust companies and corporations, and assist the Government in putting the law into operation with the least possible disturbance to established business conditions.

The law provides the tax on bond interest shall be collected at the source, but as anyone who has read the act is aware, the law fails to define the source, so that without specific instructions, any one of ten or fifteen banks through which the coupons pass might feel that in each instance they would be held responsible for the collection of the tax and consequently in order to protect themselves, each might hold out the tax. Under the Treasury Regulations the source is clearly defined, and for all interest on the obligations of domestic corporations the debtor corporation (issuing company) or its paying agent (if designated pursuant to the regulations), is the source, except where the bondholder fails to identify the class to which he belongs, by attaching an Ownership Certificate to his coupons. In this latter case the first person, bank or trust company purchasing the coupons or receiving them for collection, becomes the source and attaches to the coupons the name of the person from whom the coupons were received so that the Government will ultimately have a definite record of those from whom the tax has been withheld. The Collecting Bank also withholds the tax out of the proceeds of the coupons.

Where income is from foreign countries, in every case

* This statement relates to the methods prescribed for November 1st and thereafter. For special instructions from date to November 15th see bottom of page 11.

the first person, bank or trust company receiving the items, is the source.

The bondholders as mentioned in the regulations can be grouped into four classes:

1. Citizens of the United States or resident foreigners, who are exempt from taxation because their net income is less than \$3,000 or \$4,000, according to status of single or married.

2. Citizens of the United States or resident foreigners, whose net income is in excess of \$3,000 or \$4,000, but who are allowed exemptions up to a point of \$3,000 or \$4,000, according to status.

3. Corporations, joint stock companies, associations, etc., as fully described in paragraph G of the income tax law. With respect to such organizations the law provides the tax shall not be withheld at the source irrespective of whether or not the income is taxable.

4. Non-resident foreigners.

It will be seen from the above, that to carry out the provisions of the law, of holding out the tax *only* on a certain class of interest, it becomes necessary to identify the coupons with the owner of the bonds and ascertain the class to which the owner belongs, which can only be done when coupons are presented for payment, because when once paid coupons lose their identity.

Many debtor corporations are also interested in this classification for the reason that a very large percentage of the mortgages of corporations contain a provision to pay the interest to the bondholder without any deduction for Federal tax, although the Government is not interested in this feature one way or another.

In order that the debtor corporations can keep this covenant and at the same time assume the tax only where an individual's income is taxable, it is necessary for the debtor corporations to know the class to which bondholders belong and to what extent they claim exemptions, as otherwise the corporations might be required to pay a tax to the Government on their entire interest, which would be unjust and might lead to prolonged litigation. Under these conditions the corporations clearly have the right, before assuming the pay-

ment of the tax of individuals, to obtain from them some evidence that they are liable to taxation, and these Ownership Certificates can be accepted for this purpose.

The plan of having Certificates of Ownership accompany the coupons therefore accomplishes a two-fold purpose. First, that of saving the man with a small income the annoyance, possible expense and delay of securing a refund of tax improperly deducted when he is not liable to taxation and permitting every individual to claim exemption up to at least \$3,000 or \$4,000. Second, in permitting the debtor corporations to ascertain the individuals claiming exemptions and thereby the extent to which the tax must be assumed under the covenant.

It will be observed that the certificates required by the regulations are not in the form of affidavits, as in many cases the expense of securing an affidavit would be as much as the tax would amount to. Congress undoubtedly recognized this fact and the law provides that a claim for exemption, in a written statement, is sufficient "and that thereupon no tax shall be withheld upon the amount of such exemption," but the penalties are very severe for securing any deduction or exemption by making fraudulent representations in these written statements.

These Ownership Certificates eventually become part of the records of the Government, hence the apparent desire of the Government to secure in every instance a certificate with the name and address of the bondholder.

Where an individual claims an exemption on one of the Ownership Certificates, he fills in thereon the amount of the exemption then claimed. To illustrate, if the amount of coupons accompanying a certificate is \$100 and the individual claims exemption, he will fill in \$1.00 as the amount of exemption claimed on that particular certificate. In the same manner he will continue to claim exemptions until he has reached the limit allowed by law. Should he claim more exemption than he is entitled to it will be known to the Government, because no matter where these certificates are taken up by the debtor corporations, whether in New York, St. Louis or New Orleans, all of his certificates will un-

doubtedly eventually find their way to the Collector of Internal Revenue for the district in which he resides and be assembled under his name.

All individuals should keep a record of the amount of exemptions that they claim from time to time, so that they will not inadvertently claim more than they are entitled to in any one year. Under the law (Paragraph D) the amount of exemptions allowed for the taxable period ending December 31, 1913, is only five-sixths of the amount allowed per annum.

We will now follow these certificates through the banks, to the paying agents for the debtor corporations. We will also first consider the case where the debtor corporation has agreed to pay the interest without deduction for tax. The first certificate to come in is say that from a corporation which owns some of the bonds of the debtor corporation. The paying agent pays these coupons in full, because under the law no tax is held out against corporations, and places the certificate in the exempt pile. The second certificate is by an individual claiming exemption, or by a non-resident foreigner who is not subject to taxation, so his coupons are paid in full and the certificate placed in the exempt pile. The third certificate is that of a person who makes no claim for exemption, but here again the paying agent pays the full amount of the coupons, because in not claiming the exemption, he is in effect admitting that he has taxable income and consequently the debtor corporation performs its covenant and assumes the payment of his tax by paying to him the full face value of the coupon. Occasionally a Collecting Agent's certificate will come in, where the owner of the bonds has failed to attach an Ownership Certificate to his coupons, but here again the debtor corporation pays the full face value of the coupon because in such cases the first Collecting Bank withholds the tax. It will therefore be seen that in all cases where the mortgage contains this covenant, the entire amount of the coupons is paid by the debtor corporations as formerly. While in the case of mortgages with the covenant no deductions are actually made by the debtor corporation, it is nevertheless re-

sponsible to the Government for the amount of the tax of taxable persons, in the same manner as if it had actually withheld the tax when paying the coupons. The paying agent will place the certificates of taxable individuals in a separate pile, and when totaled, the certificates will show the amount of tax deductions for taxable persons. Before the twentieth of the following month the debtor corporation or paying agent is obliged to deliver the certificates together with a list to the Collector of Internal Revenue, and will probably prepare a statement somewhat as follows:

X. Y. Z. R. R. CO.

General Mortgage 4% Bonds outstanding	\$40,000,000
Interest on same for six months..	800,000
Interest remaining unpaid at time of last statement	50,000
	850,000
Interest now remaining unpaid...	60,000
Interest paid during month.....	\$790,000
Certificates of corporations and other organizations herewith attached, representing coupons amounting to	\$200,000
Certificates of individuals claiming exemptions herewith, for interest amounting to	250,000
\$3,300 cash, representing amount withheld for persons not claiming exemptions on interest amounting to	330,000
Certificates of Collecting Banks withholding tax on interest amounting to	10,000
Total as above.....	\$790,000

It will be seen that under the mortgages with the covenant, the manner of paying the interest will not be changed from the present methods and the records kept by the paying agent will not require alteration, but the paying agents will be obliged to take as good care of the certificates as they do of the coupons, and also see that the amounts stated on the certificates agree with the amount of coupons presented for payment. The banks handling these coupons will also proceed as formerly, except to see that certificates accompany the coupons.

In the mortgages which do not contain the covenant, the proceedings are exactly the same as described above, except with respect to individuals not claiming exemptions, in which instances the paying agent will of course deduct the tax and pay the bondholder only ninety-nine cents on the dollar. In such cases the paying agents can open "Income Tax Accounts" for each issue, on their coupon ledger, and credit thereto the amounts so deducted. These accounts can be verified from time to time by running up the amounts shown on the certificates of taxable persons.

As a majority of the mortgages contain the covenant, and as under the law no tax is held out on the obligations of the United States or its possessions, or the obligations of any State or political subdivision thereof, and as doubtless many of the bonds which do not contain the covenant are held by corporations, non-resident foreigners, and individuals with small incomes, it will readily be seen that under the plan adopted, while only a very small amount of coupons will actually be paid at ninety-nine cents on the dollar, yet the Government obtains the full tax to which it is entitled, and in such a manner that it is easy to verify the collection of the total tax on each issue of bonds, of each corporation. While this condition will last for a considerable period, the amount of coupons to be paid at ninety-nine cents will gradually increase by reason of the provision of the law casting doubt on the validity of these tax-free covenants, and corporate bonds hereafter issued will in many cases not contain the covenant; such bonds will naturally be

treated the same as is above indicated for existing bonds not containing the covenant.

Of course any foreign paying agents of United States corporations will be obliged to proceed in exactly the same manner as if they were located in the United States.

Under the regulations the debtor corporations are obliged to notify the Collector of Internal Revenue of their districts who its paying agents are. The object of this provision is doubtless so that the Government can know where to look for the collection of the tax upon the interest of each corporation.

Each debtor corporation should also immediately instruct its paying agent of its wishes regarding the tax covenant, if contained in its mortgage, and supply the agents with the tax money where a taxable person's tax is to be assumed.

FOREIGN INCOME.

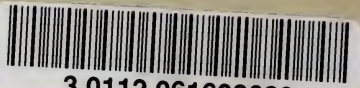
It will be observed that the tax on income from foreign securities is collected in a different manner than the tax on interest of domestic corporations, even though the foreign corporation has a paying agent in the United States. This is apparently necessary because foreign coupons deposited in the United States for collection might go directly to the foreign country for payment, instead of to the paying agent in the United States, and consequently the Government would lose taxes if the paying agent was selected as the source for this class of income. The Treasury Department has therefore apparently for this reason designated as the one to withhold the tax the first person, or bank, purchasing or accepting for collection such coupons, checks or bills of exchange, and such person or bank must procure a license. Inasmuch as no tax can be held out against corporations and non-resident foreigners, and as individuals also have a lawful right to claim exemptions on income of this character as well as domestic interest, the regulations of the Treasury Department provide that these exemptions may be claimed by certificates, the same as in the case of interest of domestic corporations,

except that the person or bank first purchasing or receiving these coupons, etc., shall retain the certificates, while the coupons, checks or bills of exchange themselves bear the evidence to subsequent holders of whether they are exempt from taxation or the tax has been withheld.

Foreign corporations having a tax guarantee clause in their mortgage will doubtless raise the question of the manner in which under this plan they can carry out their guarantee. This can be done in the following way: If the coupons presented to the foreign corporation, or its paying agent in the United States, bear the endorsement "Exemption claimed," the corporation of course simply pays the face value of the coupon. If, however, the coupon bears the endorsement "Income Tax Withheld," it will immediately become apparent that the corporation must pay the coupon at one hundred and one per cent.,—one hundred per cent. for the coupon and one per cent. for the tax which is withheld by the bank accepting the coupon for collection from the original owner. If coupons are purchased instead of being taken for collection, this one per cent. will naturally have to be taken into consideration in the price when passing from one dealer to another.

EMERGENCY PROVISION.

The regulations contain an emergency provision for coupons due November 1st which may be in transit at this time without Ownership Certificates. This permits the bank presenting such coupons to the paying agent to file a temporary certificate pending the receipt of the regular Ownership Certificate and thereby avoiding the necessity of returning the coupons to the owner for the regular certificate, which in many cases might work hardship on the owner. This provision permits the return of any tax improperly withheld, upon the receipt of the regular certificate. Debtor corporations with the tax covenant in their mortgages should explicitly advise their paying agents of their wishes with respect to this feature in connection with emergency certificate.



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